STATE OF NEBRASKA

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Increasing energy efficiency and using pollution prevention options saves money for Nebraska's businesses, organizations and communities.

Since it takes money to save money, the Nebraska Energy Office compiled this information about various financing opportunities as an aide to making energy efficiency and pollution prevention improvements. The agency, however, does not recommend or endorse one financing method over another.

40 Ways To Finance Your Improvements includes financing options in four general areas:

- ◆ Self-financing,
- ◆ Direct borrowing,
- ◆ Alternative-financing techniques, and
- ◆ Community-based financing.

The improvements being considered can influence the type of financing selected. The legal organization of the decision-maker, such as for-profit, nonprofit, local government, corporate, partnership or sole proprietorship can also determine which financing options are suitable.

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Introduction

Self-Financing

Self-financing means using cash reserves or allocating funds within capital or operating budgets.

With cash purchases the cost savings generated by the investment are immediately available. In addition, the depreciation of the equipment is tax deductible. The rate of return on energy efficiency improvements which recover their cost in less than a year is in excess of 100 percent. Few investment opportunities have comparable rates of return.

The payback on many energy efficiency and waste reduction investments is short enough that the savings in operating costs should quickly replenish cash reserves. For these reasons, relatively inexpensive efficiency improvements, which recover their cost in a year or less, are ideal candidates for self-financing.

The use of cash reserves subjects them to possible depletion. If the required investment is large it may be difficult or impossible to finance from cash reserves.

Where self-financing is used for more expensive energy efficiency improvements, it is generally more practical to allocate funds in an annual capital budget. This approach ensures that energy efficiency becomes a line item in future budgets and continues to remain an important operating consideration.

Direct Borrowing

Direct borrowing involves raising money through loans from financial institutions or through issuance of bonds.

Loans

The most common form of borrowing is a loan from a lending institution, such as a bank or savings and loan association. Loans used to finance energy efficiency and pollution prevention projects can be largely self-liquidating with projected energy cost savings serving as the means for loan repayment. Loan payments can be structured to be slightly less than projected energy savings and keep cash balances intact. Where loans are used for financing, equipment depreciation and the interest on the loans are tax deductible. The borrower bears all of the risks of the project and receives all the benefits. The loan and equipment are reflected on the company's balance sheet.

Loan guarantees and mortgage insurance are methods of credit enhancement for individual loans. In either case, the credit risk of the guarantor or insurer is substituted for the credit risk of the borrower. Loan guarantees and mortgage insurance are pledges to cover most or all of an outstanding balance on a loan made by a private lending institution in the event of default. Credit enhancements of this nature strengthen lending markets and expand the availability of credit and lower its cost.

The predominant guarantors of private loans are agencies of the federal government. The Small Business Administration and U.S. Department of Agriculture's Rural Development operate loan guarantee programs. The U.S. Department of Housing and Urban Development also has a number of mortgage insurance programs.

Bonds

If the project is very large and can justify the added expense of entry into the bond market, bonds may be issued and marketed. When bonds are used to secure funds to finance a project, the bond interest and depreciation on the energy efficiency improvements are tax deductible. The borrower bears all of the risks of the project as well as receiving all the energy savings.

The Nebraska Investment Finance Authority is authorized to issue revenue bonds or other debt instruments to raise funds to finance eligible projects. The bonds must comply with certain federal and state law requirements, allowing the interest they bear to be exempt from federal and state income taxes. The borrower must find purchasers of the bonds either by direct placement with a financial institution or by public sale using an investment banker.

The borrower and lender negotiate interest rates. Because the bonds are tax-exempt, interest rates are usually lower than rates available through commercial sources. The Nebraska Investment Finance Authority currently has two bond programs which could be used to finance energy efficiency and pollution prevention improvements: Industrial Development Bonds and Tax-Exempt Bond Financing for Rental Housing.

Alternative Financing Techniques

Leasing

Leasing of equipment is an alternative way to implement energy efficiency and pollution prevention recommendations. Major energy projects can be implemented while avoiding debt and maintaining a positive cash flow. No down payment is required and lease payments can be structured to cost less than the energy savings produced by the equipment.

A lease can be considered as an operating expense and not as adding to indebtedness. For political subdivisions, this is important where there is a prohibition against incurring long-term debt. Two types of leasing — capital and operating-are considered here.

A capital lease, also called lease purchase, is an installment purchase of equipment. Under a capital lease, the lessee on its income tax return can deduct the depreciation and the interest portion of the installment payments. At the end of the lease period, title to the property may be transferred to the customer.

Under an operating lease, the equipment is leased to the lessee for a fixed monthly fee for a specified time. The lessee is renting the equipment and is not entitled to any tax deductions by virtue of the lease. At the end of the contract period, the lessee can purchase the equipment at its fair market, renegotiate the lease or have the equipment removed.

The financing mechanism most frequently used for lease purchase is the certificate of participation. Individual investors are able to purchase fractional interests in a particular lease by purchasing certificates of participation. The certificates are generally issued in $5,000 denominations. There is an active secondary market for certificates of participation. The low denominations in which they are issued facilitate the operation of a secondary market as well as spreading the risk of the lease purchase. As a result, lease purchases financed with certificates of participation are at lower interest rates than other types of lease purchase.

Performance Contracting

Performance contracting is the implementation of energy efficiency measures by a provider of energy services, usually an energy services company, whose payment depends on successful operation of the project. Energy services companies and performance contracting are inextricably linked.

The performance contractor, usually an energy services company, obtains financing and assumes the risks of performance associated with the project. The contractor’s compensation is generally paid from the increased savings resulting from reduced energy consumption. Financing for performance contracting depends more on the cost savings potential of the project than on the financial strength of the building owner. Financing may include a variety of sources, including leasing.

Under a performance contract, the energy services company provides a services package. The package of services can vary in sophistication, ranging from a simple audit, installation and monitoring to full operation of a facility's energy systems. Performance contracts are complex and usually are not used for facilities with energy costs less than $150,000.

A typical services package includes an energy audit, design of cost-effective projects, obtaining bids, managing construction, guaranteeing energy savings, obtaining financing, and maintaining energy-saving capital improvements. The facility owner uses realized energy savings to pay for the improvement but the details of this vary.

A performance contract is a long-term commitment, therefore the contractor must be selected carefully. This would generally involve issuing requests for proposals, evaluating submissions, and defining the terms and conditions of the contract.

Community Based Financing

Recognizing that community based action is often the most effective way of furthering local goals, a number of government agencies make financing available to communities for public or private sector improvements.

Community Programs

In Nebraska, there are three predominant government agencies that provide financing:

- The Nebraska Department of Economic Development administers block grants received from the U.S. Department of Housing and Urban Development. These funds are made available for communities and counties to use for business development, direct loans, loan guarantees, or deferred loans for businesses and affordable housing. Recipients of grants for businesses loan the funds to qualifying businesses to modernize and rehabilitate their facilities. Those receiving grants for affordable housing lend the funds to developers and building owners to acquire, rehabilitate and construct housing projects.
- The U.S. Department of Agriculture's Rural Development makes funds available to rural communities for economic development and job creation projects that can include energy efficiency improvements.
- The Federal Home Loan Bank System makes grants and loans available to member banks to help foster partnerships between financial institutions and community based organizations.

A common requirement of these sources of community based financing is that lower to moderate income Nebraskans be benefited through jobs created or retained as well as being provided affordable housing. These requirements are easily met with projects that include energy efficiency improvements.

Research conducted at the American Council for an Efficient Economy has shown energy efficiency creates more jobs per dollar spent than huge projects such as building bridges or other capital intensive projects. Because energy savings are recycled within the local economy, up to 70 person years of employment can be created with each $1million invested in energy efficiency improvements.

Tax Increment Financing

Tax increment financing is a technique that local governments can use to expand its tax base to finance improvements and complete redevelopment activities. The technique is used to pay the public costs to put a redevelopment site together and prepare it for redevelopment by a private developer.

Tax increment financing allows a community to capture increases in property taxes that result from redevelopment to pay for the costs involved with the project. The tax revenue obtained by virtue of the redevelopment is called the "tax increment."

Once an area has been designated as blighted or substandard, the local government of its community development agency can proceed with redevelopment by preparing a redevelopment plan and soliciting proposals. After adopting a final redevelopment plan, the community may authorize the issuance of warrants or bonds to undertake public improvements in the designated area. The bonds are exempt from state and federal taxes. Tax increment financing can be used for fifteen years to retire the bonds.

Although tax increment financing has not been used solely for energy efficiency and pollution prevention activities, there is no reason why it could not be used for the renovation and retrofitting of public facilities to reduce pollution and increase their energy efficiency.

Tax-Exempt Financing

Low-cost tax-exempt financing is available to local political subdivisions, which include cities, counties, townships, school districts and special districts and authorities.

For purposes of exempting from federal income tax the interest on bonds issued by local governments, the term "bond" has been broadly interpreted. The interpretation includes written purchase and sale agreements entered into by duly constituted authorities, installment purchase agreements, finance leases, and other evidences of debt issued pursuant to a governmental unit's borrowing power.

The local political subdivision seeking financing for energy efficiency improvements should be aware that various forms of borrowing might qualify for tax exemption of interest. The borrower may, therefore, negotiate a lower interest rate than ordinarily available. In seeking tax-exempt financing, the borrower should consult with a tax accountant or attorney.

Other Incentives and Rebates

Many of Nebraska's electric utilities offer their customers incentives to use high-efficiency technologies that save energy and money. Utility incentives are usually a rebate of a portion of the price of the equipment installed or an energy credit. Generally, the greater the energy efficiency the higher the incentive payment will be. In addition to saving money on the cost of equipment or its use to their customers, the utilities share the expertise of their highly trained staff.

Equipment manufacturers are often sources of finance and technical assistance. Some manufacturers have direct finance programs for customers that may offer better terms than other sources of finance. In addition, rebates on equipment purchases may be available.

Tax credits may be available for redevelopment and rehabilitation projects that can include energy efficiency improvements. An example is the Low Income Housing Tax Credit administered by the Nebraska Investment Finance Authority which provides tax credits for housing projects for low-income households.